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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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Washington, D.C. 20551
Delivered via email:
regs.comments@federalreserve.gov
Docket No. R-1430; RIN No. 7100-AD87

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Ladies and Gentlemen:

Thank you for the opportunity to comment on the Basel III Capital Proposals issued by the above Agencies and based in large part on the Basel III capital accords devised by the Basel Committee on Banking Supervision (BCBS). The Iowa Bankers Association ("IBA"), is an Iowa trade association with members compromising approximately 94% of the state and national banks and federal savings banks located in Iowa. Representing Iowa banks as a not-for-profit trade association, the IBA has heard several serious concerns on these proposals from members across the state, in addition to many accounting firms serving Iowa banks – regarding whether such capital accords are appropriate for the banking system in the United States. The IBA is writing this letter today to express concerns about both the "Basel III Capital" proposal as well as the "Standardized Approach" proposal.

The IBA understands the overall goal in the Basel III proposals of strengthening capital requirements so banks can weather the storms of downturns economic cycles inevitably bring, but these rules in their entirety are more appropriate for large complex financial institutions competing in a global marketplace than for the business practices of local Iowa banks – both large and small. The IBA respectively asks that both the Basel III and the Standardized Approach proposals be repealed for the following specific reasons:

Basel III Comments

1. **Requirement that gains and losses on available for sale securities (AFS) must flow through to regulatory capital.** This part of the proposed rule requires all unrealized gains and losses on AFS to "flow through" to common equity tier 1 (CET1) capital by the inclusion of Accumulated Other Comprehensive Income (AOCI) within the CET1 calculation. Under the proposal, even daily changes in AFS securities must technically be accounted for in regulatory capital. Because interest rates, particularly on debt securities, can fluctuate frequently, the proposed rules will introduce significant volatility into capital calculations. This particular proposal however ignores the approach of analyzing all assets and liabilities and focuses on the AFS portfolio for Iowa banks.

   The timing of this proposed rule is also greatly compounding the problem, since we are now at a period of historically low interest rates. As interest rates begin to rise, capital under this proposal will move rapidly in a negative direction, as while nothing will have changed regarding the bank's tangible equity, regulatory capital ratios could be reduced rapidly. A 300 basis point rise in interest rates for example would reduce the value of many bank's securities portfolios and reduce CET1 significantly – some Iowa banks report by as much as 40-50%. This proposal therefore will introduce a significant amount of volatility into the system which is the opposite of what the goal should be.

   This will also cause many Iowa banks to reduce their balance sheets as the economy improves, simply because of the upward movement in interest rates. In addition, a related problem is allowing AOCI to flow through to CET1 capital could have a severe negative effect on many Iowa banks' lending limits. The state of Iowa in regulating state chartered banks calculates lending limits based on capital, surplus, undivided profits and allowance of loan and lease losses (the OCC has similar rules for national banks). This proposal if finalized would literally require Iowa banks to calculate lending limits daily – and again if rates increase it could have an adverse effect by reducing lending limits of Iowa banks – resulting in excess loan violations. As a result, Iowa small business, farm, consumer and mortgage customers will be adversely impacted by the reduced availability of credit under this proposal – as it will reduce the central focus for Iowa banks of making loans to members of their communities.

   As for credit risk taken in the investment portfolio, existing rules for other-than-temporarily-impaired (OTTI) investments provide a mechanism for credit losses to be reflected in capital. A natural reaction to this new proposal will be for Iowa banks to either hold fewer securities or reclassify existing portfolio assets to hold-to-maturity (HTM). This conversion to HTM would reduce the volatility of the proposal, but it comes at the enormous cost of eliminating the ability to manage the investment portfolio through different interest rate and economic cycles – and is a core tool to offset the interest rate risk in loan and investment portfolios of most Iowa banks.

   Under this proposal many Iowa banks will need to shorten the duration on investments within their portfolio, which decreases the yield and reduces the market for longer-term investments such as bank qualified municipal bonds and U.S. Agency mortgage-backed securities. For example, many Iowa community banks purchase bank-qualified tax exempt municipal bonds, which tend to have longer maturities and have a lower cost than general market municipal securities when issued. Iowa banks under this part of the proposal may be forced to reduce or eliminate these holdings. Since as a general rule municipal bonds and U.S. Agency securities tend to have longer maturities, a system wide reduction in these investments by banks could (1) put upward pressure on interest rates as U.S. Agencies pass on the higher cost of their debt; and (2) disrupt the market by leading to a higher cost of debt for cities across the state of Iowa.

It is critical when looking at this part of the proposal to also remember most Iowa banks have an extremely high ratio of core deposits to total deposits. This means Iowa banks have a very stable deposit base, and this positive liability structure gives Iowa banks flexibility to manage these risks in their current investment portfolios – and this flexibility will be completely removed under this proposal. The IBA respectfully asks that this section of the proposal be eliminated.

2. **Elimination of trust preferred securities (TPS).** Many financial institutions hold these instruments as a very cost effective source of capital, as most community banks have much more limited access to capital markets than larger regional or national financial organizations. This portion of the rule also appears to be a complete re-write of the Collins Amendment to the Dodd-Frank Act (DFA), which would have grandfathered TPS for institutions between $500 million and $15 billion. The DFA never intended for this type of instrument to be completely phased-out for community banks – and this proposal will reduce Iowa banks (who hold such instruments) ability to grow their balance sheets to better serve their customers if they have to concentrate on filling capital holes caused by changes in regulation, instead of focusing on funding of growth opportunities in communities across the state of Iowa. This proposal seems to lie in direct contradiction to not only the statute, but also our national goal to spur job growth. We would ask this section at least be made consistent with the requirements under the DFA.

Standardized Approach – Notice of Proposed Rulemaking

3. **Increased risk weighting for residential loans.** Under this proposal, the federal agencies can assign risk weights to residential mortgages based on whether the mortgage is a "traditional" category 1 mortgage or a "riskier" category 2 mortgage. Risk weights under the proposal run from 35% up to 200%. Under current law, most prudently underwritten residential mortgages are risk weighted at 50%.

   These proposed residential mortgage rules raise several issues. First, mortgages must be re-assessed after a loan structuring or modification (HAMP loans are exempt). Therefore a "category 1" mortgage could become a "category 2" mortgage if the bank does not modify the loan under HAMP. Many Iowa banks modify loans under non-HAMP methods and have a very successful track record for those borrowers who qualify by keeping them in their homes. Why should they be penalized from a capital standpoint for offering these modifications?

   Secondly, similar to the Agencies pending proposal for a "Qualified Residential Mortgage" (QRM), the proposed rules do not recognize private mortgage insurance (PMI) at all to reduce loan to value requirements – so mortgages may be subject to higher risk weights even if PMI reduces the risk on these loans. For example, a bank originating a balloon mortgage (which is now an automatic "category 2" mortgage at ***any*** LTV) at 90% LTV would have to risk weight the loan at 150% for capital reservation purposes despite having PMI. This does not reconcile at all with the loan performance Iowa banks have experienced on such loans and may cause these banks to discontinue balloon mortgages and any loans with PMI. This will have an enormous negative impact on loans to first time homebuyers in our state, as PMI has been used successfully by banks in Iowa for decades with hardly any resulting losses for prudently underwritten loans.

   Third, the proposal has no grandfather provision, so all residential mortgage loans on the bank's books would be subject to the new capital requirements – forcing banks to review all existing files to determine the appropriate category and LTV for each loan file. This "granular" approach is going to put significant pressure on Iowa banks to implement systems for calculating these new reporting requirements, and it is also questionable whether software vendors could possibly even implement this new requirement in a timely manner. Further complicating the issue, banks will not be able to just "assign" a weighting when the loan is booked, but would have to continually re-evaluate the risk weightings based on changes in collateral values, past due status and other risk factors.

Iowa banks' strong underwriting has led to a very small loss history on residential real estate loans, where this new re-evaluation approach on an asset by asset basis is completely unnecessary and should be eliminated from the proposal. These new capital proposals do not reflect the actual net charge off experience of Iowa banks both during and after this latest recession. By changing the risk weightings on 1-4 family mortgages and home equity loans, the proposals are not properly utilizing or considering the careful underwriting standards exercised by bankers across the state of Iowa.

One of the IBA subsidiary companies, the Iowa Bankers Mortgage Corporation (IBMC), acts as a residential mortgage aggregator for IBA member banks to sell secondary market loans to IBMC, who then services the loans for Fannie Mae. IBMC has been in business since 1979 and currently services over 35,000 loans originated by Iowa banks with a current value of $4.5 billion. As shown in the chart below, the delinquency rate for conventional loans sold to IBMC by IBA member banks (the red line at the bottom) has not appreciably changed in the last 14 years – and has remained stable even through the depths of the national mortgage crisis (the middle "blue" includes all types of lenders and loans originated in Iowa, i.e. mortgage brokers and subprime). The second graph shows foreclosure starts in Iowa through the mortgage crisis has maintained a consistent rate much lower than the national average. These graphs (using the Mortgage Bankers Association delinquency survey data) are a testament to the quality of the loans originated strictly by Iowa banks and shows there is no need to drastically alter the capital reservation requirements for residential mortgage loans. IBA member banks also report similar delinquency numbers (around 1%) for residential mortgage loans held in their loan portfolios. We would respectfully ask this section be eliminated from the proposal.

If the Fed, FDIC and OCC (the "Agencies") insist on banks categorizing residential mortgages into the proposed format, then the IBA believes the vast majority of loans in existence now and to be originated in the future should fall under the definition of a "category 1" mortgage as follows:

1. The DFA requires all residential mortgages to be originated according to nationwide "ability to repay" standards, and the Consumer Financial Protection Bureau (CFPB) is expected to finalize rules under this provision of the DFA early in 2013. Since all residential mortgage loans must meet this new standard – it makes sense that all such loans should be deemed to be category 1 mortgages. This measurement for capital reservation purposes should only be required at origination and banks should not be required to constantly evaluate the status of booked loans given current retail credit classification and allowance for loan and lease loss rules for delinquent loans (also discussed below).

2. All existing residential mortgage loans that are performing should be grandfathered as category 1 mortgages.

Credit enhancing representations. The proposed rules would require banks to hold capital for assets with credit enhancing representations and warranties, including "pipeline" mortgages in the process of being sold. Under the existing capital rules, banks are not required to hold capital against assets with such representations and warranties. This new requirement would affect any mortgage sold with a representation or warranty containing (1) an early default clause, and/or (2) certain premium refund clauses covering assets guaranteed, in whole or part, by the U.S. government or government sponsored entity.

Early default clauses or premium-refund clauses are very common on third party sales of mortgages. They are largely intended to protect the purchaser by providing some recovery in the event of extremely early or unanticipated pay off or refinancing, and are usually targeted at 120 days or less. They are meant to reimburse the purchaser for the expense of acquiring a loan which subsequently did not perform long enough for any expected return on investment. Instances of enforcing this pay off protection are an extremely small percentage of the overall population of loan transactions, and in any event exist to recoup perceived losses and offer some investor protection. These clauses are tied closer to operational transmission of the loan more than any risk protection as it relates to the underlying collateral.

Requiring off-balance sheet guarantees at 100 percent credit conversion during this initial time period seems very onerous in there is little evidence these temporary and expiring representations and warranties pose any significant financial exposure. The proposal is overly harsh because it applies a one-size-fits-all approach to an off-balance sheet exposure already covered by reserves on the balance sheet (FASB Interpretation 45 already requires recognition for the types of rep & warranties covered by the proposal). In addition, in many cases the reps and warranties referring to early default and premium refund clauses do not automatically subject the bank to the repurchase of the loan. Often the only liability to the bank would be to refund the servicing premium and any other earned fees on the loan. To require capital reservation for 100% of the loan is not at all commensurate with the amount of risk Iowa banks are assuming for these transactions.

Any credit enhancements or representations existing outside of this initial prepayment protection, whether as part of the contractual agreements between the parties, would amply represent the overwhelming amount of any risk on behalf of the seller. Requiring additional balance sheet guarantees for this transitional period would be a significant increase in capital needs much greater than the actual risk it is designed to represent. Requiring Iowa banks to hold capital against these temporary exposures will keep this needed capital idle while contributing minimally to the safety and soundness of IBA member banks. This rule if implemented could drive many Iowa community banks out of the secondary market and possibly out of the residential mortgage business altogether. We would respectfully ask this section be eliminated from the proposal.

4. **Change in risk weighting for home equity and second lien loans.** This part of the proposal classifies all junior residential liens, such as closed-end home equity loans and home equity lines of credit (HELOC's), as "category 2" exposures with risk weights ranging from 100-200%. More importantly and as is the case most often in Iowa banks, if they hold both the 1st and 2nd mortgages on the same property they would be required to treat ***both*** mortgages (even the 1st mortgage) as category 2 exposures (much higher risk weight).

   The exception where both mortgages could be placed into a category 1 mortgage – where the combined exposure meets all of the requirements of a category 1 mortgage, is far too narrow and most home equity loans originated by Iowa banks and their accompanying 1st mortgage would likely fall into category 2 classifications. This proposal will cause Iowa banks to seriously consider discontinuing home equity loan programs – with the tax advantages they offer Iowa homeowners over other types of consumer loans. We also ask this portion of the proposal be eliminated.

5. **Proposal to increase risk weights on delinquent loans.** Banks across the state of Iowa are fortunate with careful underwriting to have a very low delinquency rate currently, but this could change quickly based on economic conditions. This rule, which drastically and automatically increases risk weights for past due loans, causes concerns as Iowa banks already set aside reserves under existing rules for delinquent loans. This approach treats each past due loan as if there is a standard risk or impairment to capital. The IBA has heard from many of its members not all non-performing loans post the same amount of risk to capital. Well collateralized loans posing no risk to capital may be held in delinquent status until certain issues can be resolved. Conversely, under collateralized loans posing a greater risk to capital may be renewed or restructured to avoid additional capital requirements. This proposal therefore under the "Standardized Approach" would not be consistent with the goal of requiring more capital when higher risks are present.

   By proposing to increase capital on past due loans, Iowa banks would also be basically required to set aside capital twice. Risk regarding past due loans should continue to be managed through loan loss reserve guidance and not by layering on an additional capital requirement.

   This rule if finalized would require most Iowa banks to increase their aggressiveness in moving loans past 90 days delinquent off of their balance sheet – and make banks much less likely to pursue loan workout strategies and instead proceed directly to foreclosure sale.

Conclusion

In conclusion, IBA member banks have no way to completely ascertain the full impact of this massive proposal because of the amount of work it will take to understand the rules and how they apply to the banks' balance sheet. Most Iowa banks will likely be required to hire a team of consultants to implement the re-assessment of each individual loan in their portfolio with the new risk weights, re-program core processing software to handle the new coding requirements and then create the necessary reports to analyze the data.

As we stated above, while the IBA supports the overall goal of strengthening the financial system by increasing the level and quality of capital that banks hold, these rules are designed much more for large multi-billion dollar global financial institutions than the business practices of Iowa banks. The IBA urges the agencies to repeal this proposal so our members may continue serving Iowans and help strengthen our local economies.

Sincerely yours,

Robert L. Hartwig

Legal Counsel

Iowa Bankers Association